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No. 85-1744

In the Supreme Court of the United States

OCTOBER TERM, 1985

WARREN ESSNER, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether misrepresentations concerning the financial condition of an insolvent government securities dealer, made to investors to induce them to engage in securities transactions with the dealer in which the dealer's financial condition was an important element, were "in" or "in connection with" the offer, purchase or sale of securities for purposes of the antifraud provisions of the federal securities laws.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A11) is reported at 785 F.2d 38. The opinion of the district court (Pet. App. A14-A22) is reported at 606 F. Supp. 295.

JURISDICTION

The judgment of the court of appeals was entered on February 21, 1986. The petition for a writ of certiorari was filed on April 21, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The fraud in this case involved repurchase transactions, known as "repo" and "reverse repo" transactions, in government securities by Drysdale Government Securities, Inc. (DGSI). A repo is the sale of a security to an investor with an agreement to repurchase the security from the

investor at a later date at a fixed price. A reverse repo is the purchase of a security from an investor with an agreement to resell the security to the investor at a later date at a fixed price.

The wholesale repo market in which these transactions occurred is an integral part of the market for United States government securities. Securities dealers, banks and other financial institutions, business corporations, and state and local governments participate in that market. The repo market enhances the liquidity of government securities and their attractiveness to investors, thereby facilitating the government's ability to finance the public debt. Government securities dealers use this market to acquire securities to cover short positions, make delivery of securities to customers, and finance their own securities portfolios. Structuring the transactions as purchases and sales of securities reduces delays and transaction costs and thus makes practical the transfer of funds on a short-term basis.[1]

Repo transactions involving United States government securities have been viewed by some market participants as carrying minimal risk. In fact, however, parties to these transactions are exposed to the risks of changes in the market value of the securities in response to interest rate fluctuations and of default by their counter-parties when the time comes to repurchase or resell the securities.[2]

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[1]See, *e.g.*, Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess., *Report of the Joint Treasury-SEC-Federal Reserve Study of the Government-Related Securities Markets* 28 (Comm. Print 1980); Lucas, Jones & Thurston, *Federal Funds and Repurchase Agreements*, 2 Fed. Reserve Bank of N.Y. Q. Rev. 33 (1977); T. Simpson, *The Market for Federal Funds and Repurchase Agreements* 39, 50, 65 (Staff Study, Board of Governors of the Federal Reserve System 1979); N. Bowsher, *Repurchase Agreements*, in *Instruments of the Money Market* 52, 55, 58 (T. Cook & B. Summers 5th ed. Fed. Reserve Bank of Richmond 1981).

[2]See, *e.g.*, M. Stigum, *The Money Market: Myth, Reality, and Practice* 314 (1978).

2. Petitioner was a partner in the accounting firm of Arthur Andersen & Co. The Securities and Exchange Commission's complaint alleged that petitioner assisted Drysdale Securities Corp. (DSC) in the spin-off of its government securities business through the formation of a new entity, DGSI. Petitioner authored a letter for distribution to securities dealers and banks announcing the formation of DGSI and stating its capital as $20.8 million. In fact, DGSI was insolvent, burdened with a deficit of $190 million arising out of the government securities positions that it assumed from DSC. Petitioner also executed an unqualified audit opinion with respect to a certified statement of DGSI's subordinated debt and equity. The opinion was based on a purported (but improperly conducted) audit. The statement repeated the representation that DGSI had capital of $20.8 million. The opinion and statement, like petitioner's earlier letter, were distributed to government securities dealers and banks with the purpose of inducing them to deal with DGSI. Pet. App. A3-A5, A16-A17, A34-A37, A41-A42.

Most of DGSI's business involved purchases and sales of government securities through repos and reverse repos. By taking advantage of then-existing disparities in prices, DGSI was able temporarily to generate funds to meet its inherited obligations by buying securities in reverse repos and selling them outright for a higher price in the cash market.[3] In order to redeliver the securities at the close of the reverse repo transactions, however, DGSI needed funds to purchase them again in the cash market. Thus, DGSI

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[3]In the repo market, the price paid by the purchaser did not take into account accrued coupon interest, while in the cash market it did. Thus, by purchasing securities in the repo market and selling them in the cash market, DGSI was able immediately to realize the accrued coupon interest. However, it was required to remit the interest as the coupons matured. Pet. App. A9 n.3, A15-A16, A33-A34.

could meet its commitments to investors and fund its large deficit only by continuously obtaining cash by buying government securities in reverse repo transactions and selling them in the cash market. Pet. App. A9 n.3, A15-A16, A34-A37.

When several of DGSI's reverse repo customers reduced their positions, this Ponzi-like scheme collapsed. DGSI defaulted on payments of over $180 million in accrued coupon interest (see note 3, *supra*) due Chase Manhattan Bank, Manufacturers Hanover Trust Co., and their customers, and it failed to settle transactions in the cash market. In the aftermath of DGSI's collapse, Chase and Manufacturers reported net losses from DGSI's failure to meet its interest and trading obligations of approximately $300 million. Pet. App. A14-A16, A38-A40.

3. a. The Commission brought this injunctive action against petitioner and others,[4] alleging that petitioner, with scienter, prepared and certified false financial statements that were used to induce investors to trade with DGSI, in violation of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The district court dismissed the complaint. Pet. App. A14-A22. The district court concluded that petitioner's misrepresentations were not made "in" the offer or sale of securities within the meaning of Section 17(a) or "in connection with" the purchase or sale of securities within the meaning of Section 10(b) because they "related to the capitalization of

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[4]The three other individual defendants, who were officers of DSC or DGSI, consented to the entry of permanent injunctions without admitting or denying the Commission's allegations. The action against DSC was voluntarily dismissed after the firm was dissolved. Pet. App. A3 & n.1.

DGSI, not to the value of the government securities underlying the 'repo' market or the financial stability of the issuer [*i.e.*, the United States]." Pet. App. A19.

b. The court of appeals reversed and remanded for further proceedings. Pet. App. A1-A11. The court of appeals held that there was a sufficient nexus between petitioner's fraud and the securities transactions, pointing out that "securities were transferred as a direct result" of the misrepresentations of DGSI's financial condition (*id.* at A11) and that these misrepresentations "directly involve[d]" the consideration for the securities transactions (*id.* at A7).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore unwarranted.[5]

Petitioner contends (Pet. 8-19) that fraudulently inducing investors to engage in securities transactions with an insolvent broker-dealer, where the dealer's financial condition is an important element of the transactions, is not actionable under the antifraud provisions of the federal securities laws. His primary argument is that Section 10(b) of the Securities Exchange Act, as implemented by Rule 10b-5, and Section 17(a) of the Securities Act, which require that the fraud be "in" or "in connection with" securities transactions, reach only those frauds that pertain to the

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[5]The interlocutory posture of this case is also a significant factor weighing against review at this juncture. The court of appeals reversed the district court's dismissal of the complaint and remanded for further proceedings. Petitioner will therefore be able subsequently to raise again through a petition for a writ of certiorari the issue he now asserts, together with any additional questions that may arise on remand, should a final judgment be entered against him. Moreover, the Court would not at this stage have the benefit of a factual record or findings from the district court.

value of the securities themselves. This argument is contrary to both the statutory language and five decades of uniform interpretation of that language by the Commission and the federal courts. Petitioner advances no sound reason in support of his contention that this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), should be overruled.

1. a. It is well established that the antifraud provisions apply to fraudulent transactions in securities whether or not the fraud relates to the value of the securities themselves. "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.' " *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 396-397 (2d Cir. 1967), cited in *Superintendent of Insurance*, 404 U.S. at 11 n.7.[6] Petitioner's position to the contrary would undercut longstanding and important protections for the victims of fraud perpetrated by broker-dealers. Rule 10b-5 has been construed to cover a variety of fraudulent activities involving the trading process or a course of dealing in securities apart from the value of the

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[6]Accord *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 176 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978) ("the language of * * * Rule [10b-5] is broad enough to include * * * a course of dealing where the fraud concerns the overall relation of broker and customer rather than the overvaluation or undervaluation of a security sold or purchased"). See generally *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983) (Section 10(b) should be construed to effectuate its "broad proscription against fraud"); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972) ("These proscriptions, by statute and rule, are broad and, by repeated use of the word 'any', are obviously meant to be inclusive."). See also *United States* v. *Naftalin*, 441 U.S. 768, 773 n.4 (1979) (fraud that satisfies nexus requirement under Section 10(b) also comes within Section 17(a)).

securities, including such garden-variety securities frauds as churning, doing business while insolvent, and misrepresenting credit terms or trading risks.[7]

This Court confirmed this understanding of the antifraud provisions in *Superintendent of Insurance*. There, the Court upheld claims under Section 10(b) and Rule 10b-5 arising when a corporation selling United States Treasury bonds was "duped into believing that it * * * would receive the proceeds" of the sale. 404 U.S. at 9. Instead, the proceeds were misappropriated and used to purchase stock in the seller itself. The fraud did not relate to the value of the Treasury bonds. Nonetheless, the Court concluded that a federal cause of action was stated because the corporation "suffered an injury as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13.[8]

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[7]See, *e.g.*, *United States* v. *Naftalin*, *supra* (failure to disclose that securities were being sold short); *Angelastro* v. *Prudential-Bache Securities, Inc.*, 764 F.2d 939, 943-944 (3d Cir. 1985), cert. denied, No. 85-421 (Oct. 21, 1985) (nondisclosure of margin account credit terms); *Costello* v. *Oppenheimer & Co.*, 711 F.2d 1361, 1367-1368 (7th Cir. 1983) (churning); *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615 (9th Cir. 1981) (misrepresentation of risks of margin trading); *United States* v. *Peltz*, 433 F.2d 48, 53 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971) (violation of margin and short sale price rules); *R.A. Holman & Co.* v. *SEC*, 366 F.2d 446, 451 (2d Cir. 1966) (confirmation to customers of unauthorized trades); *SEC* v. *Resch-Cassin & Co.*, 362 F. Supp. 964, 978 (S.D.N.Y. 1973) (doing business while insolvent); *SEC* v. *Raymond Bliss, Inc.*, 4 S.E.C. Jud. Dec. 834 (D. Mass. 1946) (same); *In re Harold G. Wise*, 29 S.E.C. 542, 544 (1949) (same); cf. *In re Philip J. Liuzza*, 10 SEC 882 (1941).

[8]Similarly, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), the Court held that a broker-dealer violated the antifraud provisions of Section 17(a) by selling securities short through other broker-dealers that were unaware that the firm did not own the securities. Although the fraud did not pertain to the value of the securities, the Court quickly disposed of the contention that the fraud did not occur "in" their offer or sale. 441 U.S. at 773. While petitioner attempts (Pet. 18) to distinguish *Naftalin* on the ground that it related to the "existence" of the securities,

b. There is no doubt that the fraud alleged in this case satisfies the test of *Superintendent of Insurance,* as petitioner apparently admits (see Pet. 17). Indeed, although petitioner repeatedly implies that there was only an incidental relationship between the fraud and the transactions, in fact the fraud alleged here went to the heart of the securities transactions. Petitioner's false financial statements were prepared for presentation to persons who were thereby induced to enter into securities transactions in which DGSI's financial condition was a significant element. See pages 2-3, 5, *supra;* see also *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811, 815 (2d Cir. 1975) (fraud was "directly related to the trading process"). The financial statements misrepresented a critical aspect of the consideration running to the investors in the transactions. See Pet. App. A7. An integral part of a repo or reverse repo is the dealer's agreement to repurchase the security from or resell it to the investor at a fixed price (and, in the reverse repos here, to pay matured coupon interest). As the court below observed, "DGSI's financial strength was essential to the value received by the other party in a securities transaction." *Id.* at A10. Induced to trade with DGSI by petitioner's misrepresentations, the investors did not get what they had bargained for in their securities transactions. Petitioner's fraud was therefore "in connection with" the repo and reverse repo securities

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in fact the frauds are indistinguishable. In *Naftalin,* as here, the misrepresentations went to the defendant's ability to deliver the securities he had sold, and the scheme collapsed when the firm was unable to fulfill its obligations to the other parties to the transactions. See 441 U.S. at 770-771. Likewise ill-founded is petitioner's attempt (Pet. 18) to distinguish *A.T. Brod & Co.* v. *Perlow, supra,* on the theory that not intending to pay for ordered securities is fraudulent under the federal securities laws while misrepresenting that a broker is financially able to pay for such securities is not.

transactions in a sense every bit as fundamental as if he had misrepresented the market value of the transferred bonds.[9]

2. Petitioner faults (Pet. 17) the court of appeals for faithfully applying this Court's decision in *Superintendent of Insurance* to the facts presented here. There is, however, no reason to doubt the continuing vitality or the correctness of that decision.

a. Petitioner's contention (Pet. 8, 12-13) that in *Rubin* v. *United States,* 449 U.S. 424 (1981), the Court called into question its holding in *Superintendent of Insurance* is without merit. The question in *Rubin,* which the Court answered in the affirmative, was whether a pledge of stock to a bank as collateral for a loan constituted an offer or sale of securities under Section 17(a). It was undisputed that the misrepresentation related to the value of the pledged stock, so the nexus issue was not raised. The comment on which petitioner relies (449 U.S. at 429 n.6) plainly was not meant to cast doubt on the Court's holding in *Superintendent of Insurance,* which was not mentioned in *Rubin.* Read in context, the comment was obviously intended to make it clear, as other courts subsequently articulated,[10] that *Rubin* did not extend the

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[9]Indeed, the very report cited by petitioner (Pet. 19 n.10) for the proposition that additional legislation would be required to give the Commission jurisdiction over the conduct at issue here recognizes that such conduct is already covered by Sections 10(b) and 17(a):

> Fraud in connection with repurchase or reverse repurchase transactions, including misrepresentations concerning the financial condition of the brokerage firm effecting the transactions, is covered by the antifraud provisions of the federal securities laws. * * * [T]he district court's decision to the contrary in *SEC* v. *Drysdale Securities Corp.* * * * is incorrect.

H.R. Rep. 99-258, 99th Cong., 1st Sess. 17 n.22 (1985).

[10]See *Angelastro* v. *Prudential-Bache Securities, Inc.,* 764 F.2d at 946; *Chemical Bank* v. *Arthur Andersen & Co.,* 726 F.2d 930, 944 (2d Cir.), cert. denied, 469 U.S. 884 (1984).

federal antifraud provisions automatically to every fraud that might occur in the course of conventional bank loans that happen to be secured by pledged stock. Petitioner cites no decision in which *Rubin,* which was decided in favor of federal antifraud coverage, has been interpreted to overrule or otherwise undermine the continuing authority of *Superintendent of Insurance.*

b. Petitioner's argument (Pet. 8-11) that the Court in *Superintendent of Insurance* enunciated a meaningless standard that has created conflict among the courts of appeals is just wrong. The Court's decision in that case has been interpreted by the lower courts to distinguish "deceptive devices and contrivances in the purchase or sale of securities" (404 U.S. at 12), which are covered by the antifraud provisions, from "transactions which constitute no more than internal corporate mismanagement" (*ibid.*), which are not. See, *e.g., United States* v. *Newman,* 664 F.2d 12, 17 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); *Ketchum* v. *Green,* 557 F.2d 1022, 1027 (3d Cir.), cert. denied, 434 U.S. 940 (1977). Especially in light of *Santa Fe Industries* v. *Green,* 430 U.S. 462 (1977), which laid to rest any possible misconception concerning whether mere breaches of fiduciary duty are within Rule 10b-5, petitioner's characterization (Pet. 8) of federal jurisdiction over frauds as "essentially limitless" is erroneous. Rather, as petitioner elsewhere recognizes (Pet. 10), the lower courts have undertaken a case-by-case inquiry into whether a federal securities claim has been stated on the particular facts before them.

The "cautious case-by-case approach" (*Smallwood* v. *Pearl Brewing Co.,* 489 F.2d 579, 595 (5th Cir.), cert. denied, 419 U.S. 873 (1974)) adopted by the lower courts has not resulted in any conflict among the circuits. Although the precise articulation of the requirement has varied, the courts of appeals have looked for a demonstrable connection

between particular securities transactions, or a course of dealings in securities, and the alleged fraud. These courts have uniformly recognized that a fraud does not come within Section 10(b) or 17(a) simply because the particular transaction "happen[ed] to involve securities" (Pet. 18).[11] The cases cited by petitioner (Pet. 10-11) do not support his claim of a conflict.[12] Petitioner cites no case holding that the

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[11]See, *e.g.*, *Pross* v. *Katz*, 784 F.2d 455, 458-459 (2d Cir. 1986) (nexus requirement not satisfied where the fraud had "far too tenuous a connection with the securities transactions of years before"); *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d at 944 n.24 (nexus requirement not satisfied where the securities sale was "merely an incident in a transaction not otherwise involving the purchase or sale of securities"); *Ketchum* v. *Green*, 557 F.2d at 1027-1028 (nexus requirement not satisfied where purported deceptive practices occurred in connection with struggle for corporate control that occasioned forced sale of stock).

[12]Many of these cases were decided by lower courts within the Second Circuit, which of course are bound by the decision here. In any event, none of the cases on which petitioner relies conflicts with the decision here because the alleged misrepresentations in the cases finding no liability were remote from any decision to buy or sell securities, whereas here the alleged fraud directly induced investors to enter into securities transactions with DGSI. See, *e.g.*, *Ketchum* v. *Green*, 557 F.2d at 1028 (fraud was not "undertaken with the objective of inducing" the sale of stock and there were "a substantial number of intermediate steps between the fraud and the [sale]"). Nor is petitioner correct that the lower courts are in disarray. The cases he cites in support of this contention are all readily distinguishable on their facts. See, *e.g.*, *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981), cert. denied, 455 U.S. 990 (1982) (expressly distinguishing *Ketchum* v. *Green* on the ground that there was "a more direct causal connection between the fraud and the sale of securities than was present in *Ketchum*"); compare *Wilson* v. *First Houston Investment Corp.*, 566 F.2d 1235, 1243 (5th Cir. 1978), vacated on other grounds, 444 U.S. 959 (1979) (fraud too remote where plaintiff transferred control over stock portfolio to investment adviser on basis of misrepresentations concerning adviser's use of computer market analysis), with *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d at 815 (auditor violated Rule 10b-5 by accepting payoffs to provide false certified financial statements for purpose of inducing purchase of securities).

antifraud provisions are not violated where a person is fraudulently induced to purchase or sell securities through misrepresentations concerning the consideration that he would receive.

3. Finally, petitioner contends (Pet. 8, 15-16) that the decision below conflicts with *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984). To begin with, petitioner never presented this claim of an intra-circuit conflict to the Second Circuit through a suggestion of rehearing en banc, and any such conflict would of course be for that court to resolve. *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957). More important, *Chemical Bank* held only that fraud relating to the net worth of the borrower of a conventional bank loan is not covered by the antifraud provisions merely because the borrower also pledges a security. Unlike bank loans, the repos and reverse repos here were effected by a securities dealer in a securities market. DGSI entered into the reverse repo transactions for the very purpose of obtaining the securities for use in its business. It took title to those securities and was permitted to sell them, and in fact did sell them, in the market. By contrast, a bank does not lend money in order to obtain the security pledged as collateral, nor may it trade the security. In *Chemical Bank*, Judge Friendly expressly distinguished the case before the court from the situation where "sellers of securities are * * * tricked into parting with something * * * for a consideration known to the buyer not to be what it purports to be." 726 F.2d at 943. That, of course, is precisely this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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